
THE EUROPEAN ENERGY MARKET AT THE CROSSROADS

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Abstract:

This paper aims to analyse the status quo of the EU energy markets in terms of regulatory framework and degree of competition and to recommend improvements of the system in order to balance the issues of competition, energy security and environment protection in the EU energy markets.

Keywords: energy market, regulation, competition, energy security

Nowadays the European Union has to face a series of profound changes. These are characterized by privatization, deregulation and intensified competition. These challenges require an integrated policy linked to competitiveness, energy and the environment.

Even if EU has developed a world class energy infrastructure and is a global leader in many environmental policies, still significant challenges remain: completion of internal energy market, further reduction of environmental pressure, huge energy investment, a more challenging international energy market with respect to price levels and security of supply.

The future energy policy has to focus on three aspects of sustainability, in order to ensure coherence: competitiveness, environment (combating climate change is a priority) and security of supply.

For most industries, energy is essential to the cost base and competitiveness. The European industries compete internationally. Increases in energy costs can not be transferred to customers without risking reductions in market share. So, long term energy policies must be taken into account to ensure competitiveness. Access to cost-effective energy inputs for the energy-intensive sectors, energy efficiency, well functioning energy markets are issues that should be priorities for the EU officials.

Security of energy supply is of concern, as the modern society depends on energy and there is a lack of alternative sources. From supply interruptions to

persistent high and fluctuating prices, energy insecurity has various symptoms. Thinking about energy security is equivalent to managing risks.

The first oil shock brought a new responsibility to governments: providing secure energy supplies to consumers. The energy industries were at that time either owned largely by the states or were regulated as monopolies.

Economic theory predicts that monopolies will restrict output and increase price in an attempt of profit maximization. In practice, due to the fear of energy insecurity, governments made sure that investment and output were not restricted but maintained at high levels.

The late 1980s brought less attention to the energy security issue, due to the fact that the world fossil fuel market was slack and there was substantial surplus capacity in the electricity and gas supply industries, so the energy market liberalization gathered pace.

But the end of the 1990s focused again the attention on security of supply. At the turn of the 21st century, the question is not about governments handling the security problem, but about whether markets are in a position to provide adequate security and the means to manage the associated risks.

Of course, no energy system is totally secure. In theory the optimal level of security is at a point where consumers' valuation of extra security is just offset by the costs of providing it. In practice it is difficult to find this optimum, so government policy aims to keep security level within a zone of adequacy. Such a policy objective does not necessarily imply government intervention. Competitive markets are able to deliver adequate security levels. But also in the market system, failures may occur. Market or political failures may prevent markets from achieving the security objective.

There are different possible market failures, like: public good characteristic of energy security, lack of relevant information in competitive markets. But there are also potentially serious political failures: impact of environmental policy on investment incentives, the impact of emissions control on operating flexibility of plants. Market players are able to anticipate such failures and to plan to compensate for them, but this can imply more costs for a given level of security.

There are significant discussions around the central role the government should play in providing adequate levels of energy security, arguing that there are imminent threats and governments have to restore the levels of security, disguising in reality the lobby on behalf of special interest groups.

When discussing about energy security, there are two types of beliefs:

- The achievement of greater diversity in the fuel sources is a priority (coal, natural gas, renewable, nuclear power); but diversity should apply also in other areas not only fuel sources: number of competing firms in the market, supply routes of fuel, technologies.
- Energy imports reduce security and should be minimised. But by definition imports increase the diversity of sources, which enhances security and reduces costs (you don't import at higher costs but at lower).

Securing new supplies of fossil fuels is difficult and presents geopolitical risks. New technologies associated with alternative sources of energy involve significant levels of uncertainties. The prospect of decreasing energy demand brings fear with respect to consumers' comfort.

Research developed by McKinsey Institute shows that the growth of worldwide energy demand can be cut in half or more over the next 15 years without affecting the benefits to the end user. The solution is a concerted global effort to increase energy productivity (amount of output achieved per each unit of energy consumed). But market forces alone can not produce these outcomes due to information gaps, market-distorting subsidies, and inadequate financing infrastructure. To overcome these barriers, policy makers should make the price and use of energy more transparent, create new market-clearing and financing mechanisms, and selectively implement demand-side energy policies, while also encouraging demand-side innovation by companies.

Undoubtedly there are many security risks. The task of liberalised energy markets is to manage these risks effective and efficient. Only where market or political failure exist that will impede an effective management is there a case for state intervention. And the best intervention is removing the barrier rather than direct action in the market. Markets are generally well informed and powerful enough to provide adequate security levels.

Liberalisation of energy markets is a long process. One of the overall aims of liberalization is to increase efficiency through the pressure of competition. Greater efficiency leads to lower costs and prices, which is improving competitiveness – crucial for companies that are competing in a more global market.

As liberalization and the introduction of competition becomes more widespread across Europe this should lead to further efficiency gains, cost reductions and the potential for lower prices.

A completely open European market will allow all consumers to benefit from the cheapest available sources of energy and will drive companies' costs down.

The current situation is not satisfactory, despite the significant progress realized. The level of competition between Member States, but also across borders, is not enough to ensure competitive prices. Energy markets are still largely national.

The current regulatory framework should be improved and implemented to create enough competition in the EU energy market. There is a regulatory gap between the competences of national regulatory agencies and the need to coordinate regulation at the European Union's level. Building an EU market by integrating well functioning regional markets is a priority.

In the same view, at the beginning of September 2007, the European Commission was proposing a large reform of the energy market. The aim of the reform is to eliminate the dominant positions of large European groups that act in the electricity and gas market, like are the giants E.ON and Electricite de France. Energy companies will be forced to sell or transfer there transmission networks towards an independent operator. The European officials consider that these measures will

increase the investments in the infrastructure and will encourage the access of new operators.

As the President of the European Commission, Jose Manuel Barroso, is saying: "We need a common European response to combat climate change, to achieve greater energy security and provide abundant energy at a fair price for citizens... This is only possible if we have a competitive gas and electricity market."

The European officials also focus on the energy companies outside EU, trying to limit their influence in the market. In the same time, they want to eliminate the energy monopolies in Europe in order to increase competition, and to determine the price reduction.

The new regulatory package is considering also the creation of pan-European energy regulators. There is for the first time announced a solidarity clause which recommends supporting any member state that has energy reserves threatened.

The liberalization of the European energy market is forbidding the providers of electricity and gas to ensure also the distribution. But this may be risky for the European Union that can become vulnerable in front of other countries that use energy as a political weapon.

In addition, EU has no legal instruments to not allow foreign companies to acquire a significant part of the European energy infrastructure. For instance, Gazprom is the only provider of energy in 5 EU member states. The expansion of Gazprom (Gazprom provides 25% of the Europe's gas) in Europe will be difficult to impede, especially now when Europe announces the liberalization of the energy market. This allowed Gazprom to sign contracts with companies from Germany, France, Italy and East European countries. In countries like Russia and Algeria (the most important gas providers of Europe) the extraction and transport of gas is controlled by state owned companies: Gazprom in Russia, Sonatrach in Algeria.

The European energy market is theoretically free and subject to competition since July 1st, 2007 (according to the new EU electricity and gas directives from 2002). Practical, in many countries, consumers can not choose their provider. So, the new legal package promises to diversify the choice, but there can be no guarantees that prices will drop.

The process of liberalization of the energy market can bring concerns about the social and environmental aspects of the transformation. A competitive market can bring wider social benefits while existing in a right regulatory framework.

A strong framework for regulation is essential in order to benefit from a more efficient, innovative industry. The benefits may include lower prices, technological advances and international competitiveness for companies.

Central and Eastern Europe have to play a major role in the EU energy market. These countries have to develop an appropriate regulatory framework, integrated with the EU policies. In this respect, completion with the requirements of the EU directives for electricity and gas and creation of the foundation for market development based on market-driven criteria and competition are a must. The

objective should be: as much market as possible, as little regulation as necessary. This concerns especially the introduction of market prices.

In the view of opening the energy market, one important aspect is to establish the rules on how prices should be calculated. In the open market, consumer prices will be determined by competition. To be successful in such competitive environment, the energy companies have to improve their efficiency, and the regulatory framework should already anticipate this development.

It is possible that full competition avoids problems common to partial deregulation. If a market is split between competition and monopoly, firms that serve both segments will tend to load costs onto the monopolistic one. Moving to full competition avoids the regulatory problem of trying to eliminate such cross-subsidies.

Competition is in general preferable to monopoly, but not all consumers will benefit from introducing competition.

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